

A WEALTH EFFECT*

During the current record U.S. economic expansion, particularly over the last few years, Americans have been spending — a lot — and then spending some more. In fact, since 1995 real personal outlays in the United States increased at a strong pace — on average, about 4.1 percent per year.

Strong consumer confidence from a robust economy and a low-inflation environment are surely contributing to Americans' quest to buy goods. But something else may be encouraging people to spend, and it's probably not personal income, which grew on average about 3.3 percent between 1995 and 1999. The question is, What?

THE WEALTH EFFECT

Many people believe that the sustained increase in consumer spending out of current income may be the result of a "wealth effect." While this wealth effect was a somewhat remote concept bandied around in the past by those in economic circles, today it's being discussed by many Americans, particularly people seeking an explanation for the recent consumer spending spree.

In economic terms, the wealth effect under discussion is an increase in aggregate expenditures brought on by increases in household financial and nonfinancial asset holdings. Expressed another way, for every dollar someone gains in asset appreciation, she will spend part of it even if she doesn't realize the appreciation by selling the asset.

TAKING STOCK

Research suggests that people have historically spent three to four cents out of every additional dollar of stock market wealth. Some believe that the increase in outlays in excess of increases in income have added, on average, about 1 percentage point to the annual growth of gross domestic purchases in the past five years. In 1999, 1 percent of GDP equaled approximately \$92.5 billion, which is serious spending.

And more people appear to own stock — either outright or through mutual funds, 401(k) retirement accounts or other managed assets — than in previous decades. The Federal Reserve Board's 1998 Survey of Consumer Finances shows the dramatic change. According to the findings, approximately 48 percent of the families participating in the survey either directly or indirectly held stock in 1998 versus approximately 31 percent in 1989. Half of that gain took place between 1995 and 1998.

Not surprisingly, family asset values increased considerably, at least on paper, during that same period. Based on calculations from Federal Reserve Board and U.S. Census Bureau data, families' unrealized capital gains — on assets such as businesses, real estate and stocks — rose annually by a per family mean of approximately 39 percent between 1995

* Reprinted from the Federal Reserve Bank of Atlanta's Second Quarter 2000 *EconSouth*. The views expressed in *EconSouth* are not necessarily those of the Federal Reserve Bank of Atlanta or the Federal Reserve System.

and 1998. Unrealized gains are gains in the value of assets that are yet to be sold. So while more Americans own stock and while their assets have by and large appreciated considerably during the past several years, does that mean that people will automatically spend more of their current income based on the assumption of a future return?

TABLE 1
Reported Effects of Trends in Stock Prices
on Saving and Spending in the Past Few Years

Reported effect	Percent of stockowners Reporting each effect
No effect	85.0
Spend more/save less	3.4
Not specified	2.6
Bought a car	0.4
Bought a house	0.1
Gave more to charity	0.1
Took more vacations	0.1
Spend less/save more	11.6
Not specified	7.2
Invested in the stock market	3.3
Increased 401(k) contributions	0.7
Increased mortgage payments	0.4

Note: Stock-owning households were asked, "Have you [has your family] changed the amount of money you spend or save as a result of the trend in stock prices during the past few years?" If yes, they were asked, "How was your spending or saving changed?" and the response was recorded verbatim.

Sources: Federal Reserve Board of Governors Working Paper 1998-20 and Michigan Survey of Consumers

Not according to Martha Starr-McCluer, an economist at the Federal Reserve Board, who in a 1998 working paper evaluated several monthly surveys from the University of Michigan's Survey of consumers conducted in 1997. In her research, Starr-McCluer mentions that the vast majority — 85 percent — of stockholders reported no appreciable effect of stock prices on their spending or saving (see Table 1). Only 3.4 percent of the

TABLE 2
Reasons for Not Liquidating Assets of
Lowering Savings in the Next 12 Months

Reason	Percent of stockowners with no plans to liquidate assets or lower saving
Saving for retirement	45.0
Don't need the money right now	33.9
Saving for precautionary reasons	17.6
Illiquidity of gains	9.7
Saving for major purchase	7.9
Saving for education	7.6
Saving to buy a home	3.5

Note: Figures are computed for the 69.5 percent of the stockholders reporting no plans to liquidate assets or lower saving in the next 12 months. Respondents could give more than one reason. The category "illiquidity of gains" includes "cannot withdraw till retirement," "would have to pay penalties for early withdrawal" and "would lose interest if withdrew money early." Sources: Federal Reserve Board of Governors Working Paper 1998-20 and Michigan Survey of Consumers.

household stockholders in the survey said that they increased their spending or lowered their saving as a result of higher stock prices. Interestingly, in those same University of Michigan surveys, approximately 70 percent of the respondents owning stocks said that they had no plans to liquidate assets to make purchases or to save less in the next year. The most common response by participants was that they were saving for retirement (see Table 2).

The stock market and consumer spending, however, may be related, but only passively. That's because, as Starr-McCluer reasons, the stock market is a passive predictor of information. Stock prices, she argues, may simply lead aggregate economic activity, with the market anticipating a pickup in production and employment that eventually translates into higher consumer spending.

Clearly, consumers have been on a buying binge, but Starr-McCluer's research seems to back up the belief of many economists and even some manufacturers that wealth gains have only a modest impact on current spending. Instead, she says that her results support the life-cycle view that predicts only modest effects of wealth gains on current spending, as spending gains would be distributed over a household's lifetime.

WHAT ARE THE POLICY IMPLICATIONS?

Aside from consumers, policymakers with their finger on the pulse of the nation's economy have also been intrigued by the concept of the wealth effect, particularly as spending has remained so strong during the current record economic expansion.

A key question for policymakers considering the impact of the wealth effect is whether the historic relationships between changes in wealth and expenditures still hold.

If the wealth effect is pushing consumer spending, there are some questions that policymakers must ask themselves, such as how they should assess the macroeconomic effects of increased consumer spending and whether personal saving is out of balance with spending.

In describing how the wealth effect has worked in the U.S. economy, Fed Chairman Alan Greenspan summed it up this way in a speech earlier this year. "A substantial part of the excess growth of demand over potential supply owes to a wealth effect, induced by the rising asset prices that have accompanied the run-up in potential rates of return on new and existing capital. The rise in stock prices, as well as in the capital gains on homes, has created a marked increase in purchasing power without providing an equivalent and immediate expansion in the supply of goods and services. That expansion in supply will occur only over time."

But does that mean that the wealth effect is causing a significant imbalance, one that could bring on inflationary pressures if demand is growing faster than supply? Going a step further, would this potential imbalance be enough to cause the Federal Reserve to take some measure to lessen the run-up in wealth, such as targeting a level for the stock market?

Not according to Greenspan, who in that same speech said, “The persuasive evidence that the wealth effect is contributing to the risk of imbalances in our economy does not imply that the most straightforward way to restore balance in financial and product markets is for monetary policy to target asset price levels. Leaving aside the deeper question of whether asset price targeting is an appropriate governmental function, there is little, if any, evidence that monetary policy aimed at achieving that goal would be successful.”

Along similar lines, some people have also expressed concerns about whether consumers are spending too much and saving too little. Based on Federal Reserve Bank of Atlanta estimates, the personal savings rate may not be as low as some contend: unrealized gains in people’s net financial assets, including an appreciation of 401(k) funds, if marked to market would boost the estimated personal savings rate to nearly 12 percent. If these estimates are correct, the rate of personal savings may not be as significant a concern as some suspect. What’s more, the increase in consumer debt may not reflect a worrisome burden if balance sheets are strengthened by increases in wealth holdings.

Whether or not the wealth effect is encouraging consumers to spend more is a question for debate. What is clear, though, is that consumers continue to spend at very high levels, levels that show few signs of declining.